

Debt Recharacterization During an Economic Trough: Trashing Historical Tests to Avoid Discouraging Insider Lending

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⁺ *Editors' Note:* The Editors of the *Ohio State Law Journal* report with regret that this Note is being published posthumously.

I. INTRODUCTION

Over the last twenty years, the bankruptcy doctrine of debt recharacterization has been primarily used by creditors to question whether an insider's¹ "loan" transaction with a company was in fact an equity contribution, entitled to lower repayment priority in bankruptcy.² Insiders are likely to become a more significant source of financing for close corporations because of increasingly hesitant outside lenders and limited access to capital markets, given the current economic climate.³ Furthermore, business

¹ 11 U.S.C. § 101(31) (2006):

The term 'insider' includes— . . . if the debtor is a corporation— (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor

² See *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.)*, 453 F.3d 225, 229 (4th Cir. 2006) [hereinafter *Dornier Aviation*] (parent corporation owned 100% of debtor); *Cohen v. KB Mezzanine Fund II, L.P. (In re Submicron Sys. Corp.)*, 432 F.3d 448, 451–52 (3d Cir. 2006) [hereinafter *Submicron Sys.*] (insiders holding seats on debtor's board loaned \$20 million in exchange for subordinated notes); *Bayer, Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 731–33 (6th Cir. 2001) (insiders advanced funds to lender to enable additional loans); *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1465–66 (5th Cir. 1991) (creditor deemed insider of debtor); *Estes v. N & D Props., Inc. (In re N & D Props., Inc.)*, 799 F.2d 726, 728 (11th Cir. 1986) (challenge to controlling shareholder's secured claim to funds loaned to debtor for payment of consumer creditors); *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.)*, 353 B.R. 820, 838 (Bankr. D. Del. 2006) (creditors committee sought recharacterization of insider-lender loans as equity); *In re Micro-Precision Tech., Inc.*, 303 B.R. 238, 240–47 (Bankr. D. N.H. 2003) (transaction whereby original loan altered via debt conversion agreement into preferred stock then reconverted back to debt not recharacterized as capital contribution); *Citicorp Real Estate, Inc. v. PWA, Inc. (In re Georgetown Bldg. Assocs., Ltd. P'ship)*, 240 B.R. 124, 125–26 (Bankr. D.C. 1999) (partner advances to debtor-partnership determined capital contributions not loans); *In re Cold Harbor Assocs., L.P.*, 204 B.R. 904, 914 (Bankr. E.D. Va. 1997) (determining that debtor's limited partners made equity contributions and therefore had no "claim" in bankruptcy); *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 626–27 (Bankr. N.D. Fla. 1990) (shell corporation existing solely to pass funds from debtor's largest shareholder to debtor "on an as needed basis" to expand debtor's business).

³ Simona Covell, *Slump Batters Small Businesses, Threatening Owners' Dreams*, WALL ST. J., Dec. 26, 2008, at A1 ("In October, the most recent data available, the Federal Reserve Board reported that 90% of U.S. banks had tightened lending standards on small businesses in the previous three months. That hurts young businesses that need to finance growth.").

bankruptcies have risen in the past year, a trend that should continue into the near future.⁴ The combination of increased insider financing and potential bankruptcy filings will present courts with creditor committee assertions that an insider's "claim" against the debtor in bankruptcy must be "recharacterized" as an equity interest because it does not realistically represent a debt obligation of the debtor.⁵

The ramifications of debt recharacterization are severe, removing parity between similarly situated creditors with respect to purported debt transactions.⁶ Therefore, the remedy must be carefully applied such that a

⁴ See Rebecca Wilder, *The Hottest Trend in 2009: Declaring Bankruptcy*, ROUBINI GLOBAL ECON., Dec. 29, 2008, http://www.rgemonitor.com/financemarkets-monitor/254903/the_hottest_trend_in_2009_declaring_bankruptcy. Retail bankruptcy filings have increased from thirteen in the fourth quarter of 2007, eleven in the first quarter of 2008, and twelve in the second quarter of 2008, to twenty in the third quarter of 2008. *Id.* 2008 third quarter business bankruptcy Chapter 11 filings increased by 50%. *Id.*

⁵ The Bankruptcy Code defines "debt" as "liability on a claim." 11 U.S.C. § 101(12). A "claim" is a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . ." *Id.* § 101(5)(A). "Equity" is not defined in the Code, but "equity security" is, meaning a "share in a corporation, whether or not transferable or denominated 'stock', or similar security . . . interest of a limited partner in a limited partnership . . . or . . . warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind [previously] specified . . ." *Id.* § 101(16).

⁶ The Bankruptcy Code regulates payments from the debtor's estate in Section 726(a). *Id.* 11 U.S.C. § 726(a). The priority hierarchy is as follows:

(a) Except as provided in section 510 of this title, property of the estate shall be distributed—

(1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title, proof of which is timely filed under section 501 of this title or tardily filed on or before the earlier of—

(A) the date that is 10 days after the mailing to creditors of the summary of the trustee's final report; or

(B) the date on which the trustee commences final distribution under this section;

(2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3), or (4) of this subsection, proof of which is—

(A) timely filed under section 501(a) of this title;

(B) timely filed under section 501(b) or 501(c) of this title; or

(C) tardily filed under section 501(a) of this title, if—

debt transaction is not recharacterized as equity merely because it emanated from an insider source or because its terms reflected an anomalous economic condition.

The judicially created doctrine of debt recharacterization is thoroughly embedded in the vast majority of federal bankruptcy, district, and circuit courts that have heard the issue.⁷ Nevertheless, its application varies between circuits and among states; therefore, it is slightly misleading to call debt recharacterization an established doctrine. Judicial application, as exemplified by two recent circuit court decisions, *Dornier Aviation*⁸ and *Submicron Systems*,⁹ has coalesced around two overarching inquiries: either (1) whether the transaction reflects an arm's length negotiation (evidenced by a loan's objective terms),¹⁰ or (2) whether the intent of the parties was to create a debt.¹¹ Such tests scrutinizing the substantive reality of a challenged loan to a company originate from eleven non-dispositive factors used to distinguish debt from equity in a Sixth Circuit tax law case (the "*Roth Steel*"

(i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

Id. Payments to the debtor are last in line in a bankruptcy payout, creating incentive to avoid a transaction being classified as equity. *Id.*

⁷ See *supra* note 2.

⁸ *Dornier Aviation*, 453 F.3d 225.

⁹ *Submicron Sys.*, 432 F.3d 448.

¹⁰ *Dornier Aviation*, 453 F.3d at 234.

¹¹ *Submicron Sys.*, 432 F.3d at 457.

factors).¹² The twenty-plus years of circuit court debt recharacterization analysis in bankruptcy cases¹³ have established an inconsistent, ambiguous, and therefore flawed remedy for parties challenging an insider's claim against the bankrupt debtor's estate.

Indeed, "[t]he many different factors employed to determine if courts should treat an alleged loan as a capital contribution make it difficult for both lenders and corporate borrowers to predict how the court will view individual transactions."¹⁴ Insider loans are often made with the "hope of financing a successful rescue attempt" from bankruptcy.¹⁵ Courts must not inadvertently prohibit a company's most readily available source of funding by imposing on insiders an unreasonable fear of loan invalidation because of the existing capricious doctrine of debt recharacterization.

This Note will argue that, with regard to insider loans, courts must largely scrap their traditional debt recharacterization analyses. The risk to business welfare from underinvestment—bankruptcy resulting from irrationally avoiding positive investments—is greater in this economy than the risk of overinvestment or financing bad ideas.¹⁶ However, debt

¹² See *Bayer Corp. v. Masco Tech., Inc. (In re Autostyle Plastics)*, 269 F.3d 726, 749–50 (6th Cir. 2001) (citing *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625, 630 (6th Cir. 1986)).

¹³ See My Chi To & Matthew D. Siegel, *Debt Recharacterization Looks Back on a Good Year*, 26 AM. BANKR. INST. J. 1, 58 (2007) ("Arguably the first circuit to endorse debt recharacterization was the Eleventh in [*In re N & D Properties*] . . .").

¹⁴ Jo Ann J. Brighton, *Capital Contribution or a Loan? A Practical Guide to Analyzing Recharacterization Claims (or, When is Equitable Subordination the Appropriate Analysis?)*, 21 AM. BANKR. INST. J. 1, 42 (2002).

¹⁵ Martin Gelter, *The Subordination of Shareholder Loans in Bankruptcy*, 26 INT'L REV. L. & ECON. 478, 478 (2006).

¹⁶ See Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575, 603 (1995) ("[U]nderinvestment may be relatively intractable."). Professor Adler seems to favor market efficiency, arguing overinvestment is a substantial risk and that courts unfortunately "feel they are serving investors when they decline to void repayments of loans made to 'save' financially distressed firms." *Id.* at 605 (citing *Union Bank v. Wolas*, 502 U.S. 151, 159 (1991)). While I do not disagree with Professor Adler, I argue the opposite because of unique financial conditions: capital markets are unwilling to extend project financing, commercial paper availability for ordinary business operation is locked up, and creditors are irrationally reserved. Therefore, businesses face extremely heightened risks of failure not due to quality of business plans, consumer demand, or sound capital structures, but because diminished market confidence has limited available credit, exacerbating an underinvestment problem. Therefore, companies need to turn to insiders for financing, and/or loan terms that are necessarily more similar to equity. Exacerbating the underinvestment problem is that recharacterization, a growing

recharacterization encourages underinvestment. Recharacterization as it currently exists is a remedy that unreasonably discourages financial support of a struggling company's potentially successful business endeavors.¹⁷ Insider lenders simply have no concrete legal basis to know what will constitute a valid loan that will be respected in bankruptcy.

Traditional debt recharacterization analyses are also flawed because they attribute determinative significance to often irrelevant and inconclusive aspects of an insider/company transaction. This Note will assert that the important inquiry in a debt recharacterization analysis is a close critique of the individual debtor and the contract entered into with the "lender." Factors necessary and sufficient to this analysis are: interference with other creditors and the loan's "visibility" or openness to existing and future creditors; whether the transaction involves positive or negative covenants; and the existence and type of a repayment plan accounting for both principal and interest. These inquiries better characterize the often blurred distinction between debt and equity transactions and create an element of simplicity lacking in the debt recharacterization jurisprudence. As a result, insiders extending funding to troubled companies will have better notice of their risk-exposure in bankruptcy.

This Note will begin by giving a brief background of debt recharacterization and showing how it supplements existing bankruptcy causes of action for creditors and trustees in bankruptcy to avoid claims

judicial response to whether insider loans in bankruptcy will be respected or treated as equity, is capricious and fails to address current economic realities.

¹⁷ See, e.g., David A. Skeel, Jr. & Georg Krause-Vilmar, *Recharacterization and the Nonhindrance of Creditors*, 7 EUR. BUS. ORG. L. REV. 259, 268 (2006). Skeel and Krause-Vilmar see the issue of insider desire to extend loans to their companies as instinctual:

A natural inclination of the principal shareholders of a floundering business is to look in their own pockets (and often the pockets of friends and relatives) for cash to plug the leaks. They see the problems first, and they may conclude that arranging an outside loan would be too time-consuming and uncertain. Better that those who know the business best provide the funding themselves.

Id. However, if all shareholder loans were inevitably "good money, badly spent," prohibiting such inefficiency would be the proper course of action. *Id.* at 271. Clearly this is not the case. See Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 537-41 (1977). Clark's article, in part, assessed the propriety of automatic subordination of controlling shareholder claims to the claims of other creditors. For Clark, an "argument urged against an automatic subordination rule is that controlling shareholders are frequently . . . the only persons willing to lend to a small, unknown corporation on 'reasonable' terms. It is contended that if the insiders' creditor claim is not respected in bankruptcy, this source of funds may dry up." *Id.* at 538.

against the debtor. In Part III, this Note will summarize the two recent circuit court decisions that demonstrate the need for a changed approach to debt recharacterization. Part IV focuses on four aspects of judicial analysis that receive the lion's share of attention in recharacterization actions and explains why they are inapt options when investigating the true status of a transaction in light of current economic conditions. Finally, Part V sets out new inquiries that address ambiguities in classification, recognizing existing—although easing—extenuating economic circumstances surrounding insider financial transactions. Such inquiries will provide more certainty to recharacterization analyses, a necessity to encourage support of positive business endeavors.

II. RECHARACTERIZATION BACKGROUND

This section will begin by briefly discussing the development of debt recharacterization.¹⁸ This section will then note other Bankruptcy Code-based claim avoidance remedies: equitable subordination, fraudulent transfers (fraudulent conveyance law), preference law, and non-Code-based remedies such as breach of fiduciary duties and piercing the corporate veil.¹⁹

¹⁸ Beyond assessing the existence of recharacterization as an additional claimant remedy in a bankruptcy proceeding, this Note attempts to avoid adding to the sizeable commentary on the *authority* of courts to recharacterize debt. For exhaustive explanations of both sides of the story, see Neil M. Peretz, *Recharacterization in the Ninth Circuit: Has the Supreme Court Finally Derailed the Pacific Express?*, 17 J. BANKR. L. & PRAC. 297, 297–98 (2008) (arguing that debt recharacterization is textually based in the Bankruptcy Code and that state and federal security laws require a proper characterization of debt and equity, therefore legitimizing the doctrine); see also James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1257–78 (2007) (outlining the conflicting lines of cases regarding debt recharacterization that have developed within the circuits); Kenneth N. Klee & Laine Mervis, *Recharacterization in Bankruptcy*, 2005 A.L.I.-A.B.A. CH. 11 BUS. REORGANIZATIONS 211, 215 (stating that the Supreme Court's decision in *Grupo Mexicano De Desarrollo v. Alliance Bond Fund*, 527 U.S. 308 (1999), “may lend support to the minority position that recharacterization is not a legitimate exercise of a bankruptcy court's general equitable powers under [Section 105(a)]. Recharacterization is neither authorized by statute nor a traditional equitable power. Just as in *Grupo Mexicano*, it may be that to permit bankruptcy courts to recharacterize claims under Section 105 would be to adopt a rule not of flexibility, but of omnipotence.”).

¹⁹ The “veil piercing doctrine” is applicable to this discussion in that it allows creditors to request a court hold certain insiders personally liable for the company's obligations. See Skeel & Krause-Vilmar, *supra* note 17, at 260–61.

A. A Brief History of Recharacterization

Regardless of a court's ultimate decision about whether it has the authority to recharacterize debt as equity, courts presented with the issue routinely begin their analysis by stating that bankruptcy courts are endowed with general equitable powers²⁰ and must uphold economic substance²¹ over the form or name parties have given a particular transaction. Courts finding that such authority encompasses changing the label of a transaction to reflect its true economic substance hold that the Code therefore embraces debt recharacterization.²² Most courts have decided that the Supreme Court's decision in *Pepper v. Litton*,²³ making it incumbent upon bankruptcy courts to exercise their general equitable power to give effect to the economic substance of a transaction, affirmed their debt recharacterization power. On the other hand, some courts believe that general equitable principles are limited to carrying out the express provisions of the Bankruptcy Code.²⁴ No

²⁰ 11 U.S.C. § 105(a) (2006). Section 105(a) authorizes bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." *Id.* See *Submicron Sys. Corp.*, 291 B.R. 314, 322 (Bankr. D. Del. 2003) ("Bankruptcy courts have long been recognized as courts of equity."). Similarly, the United States Supreme Court has stated that a bankruptcy court's equitable powers ensure that "substance will not give way to form, that technical considerations will not prevent substantial justice from being done." *Pepper v. Litton*, 308 U.S. 295, 305 (1939). See also Brief of Appellee at 21–22, *Dornier Aviation*, No. 05-1930 (4th Cir. Nov. 23, 2005) (compiling cases relying on Section 105(a) for power of debt recharacterization).

²¹ To & Siegel, *supra* note 13, at 58; see also *Dornier Aviation*, 453 F.3d at 231 ("If the court were required to accept the representations of the claimant, as GMBH appears to argue, then an equity investor could label its contribution a loan and guarantee itself higher priority—and a larger recovery—should the debtor file for bankruptcy.").

²² The Fourth Circuit in *Dornier Aviation*, discussed *infra*, takes this reasoning one step further by holding that the Code provides express statutory authority to change the parties' characterization from debt to equity in Section 726(a)'s priority payment scheme. *Dornier Aviation*, 453 F.3d at 231–34; see *infra* note 64 and accompanying text. It is notable that the Fourth Circuit's decision in *Dornier Aviation* was the first to actually find such a "clear" statement of the authority to recharacterize debt as equity—thanks to the Fourth Circuit, the doctrine is no longer floating in equity.

²³ 308 U.S. 295 (1939).

²⁴ See generally *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) ("bankruptcy courts must and can only" exercise their powers "within the confines of the Bankruptcy Code"). See also *Unsecured Creditors' Comms. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (In re Pac. Express, Inc.)*, 69 B.R. 112 (B.A.P. 9th Cir. 1986); *In re Airadigm Commc'ns, Inc.*, 376 B.R. 903, 909–10 (Bankr. W.D. Wis. 2007) (holding recharacterization of a claim is never an appropriate exercise of a

Code section calls for debt recharacterization. Therefore, the reasoning goes, debt recharacterization is an improper extension of equitable power. Nonetheless, recharacterization authority is widely and quickly catching on—courts often give no basis (other than precedent) for undertaking a recharacterization analysis.²⁵

Debt recharacterization's circuit court genesis lies in the Eleventh Circuit.²⁶ The court in *In re N & D Properties, Inc.* stated that only two instances justify deeming a shareholder loan a capital contribution: "where the trustee proves initial under-capitalization or . . . that the loans were made when no other disinterested lender would have extended credit."²⁷ The court did not specifically address "debt recharacterization," but it laid the groundwork for future recharacterization analysis by stating that courts have the power to change a loan into a capital contribution for bankruptcy purposes.²⁸ A circuit court did not consider debt recharacterization again until the Sixth Circuit²⁹ adopted an eleven factor balancing test from a prior Sixth Circuit tax case distinguishing debt from equity.³⁰ However, the interim period between such circuit decisions (and even prior to *In re N & D Properties, Inc.*) was filled with numerous bankruptcy court opinions on point. Only five bankruptcy courts have actually exercised their stated power of recharacterization.³¹

bankruptcy court's authority because the Code views "claims" broadly, and once that threshold has been satisfied courts are not to look further into the claim's proper priority).

²⁵ See, e.g., *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1297 (10th Cir. 2004) (jumping into a comparison of debt recharacterization and equitable subordination without discussing a Code-based foundation for undertaking the debt recharacterization analysis).

²⁶ See *To & Siegel*, *supra* note 13; see also *supra* note 13 and accompanying text.

²⁷ 799 F.2d at 733.

²⁸ *Id.*

²⁹ *Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001).

³⁰ *To & Siegel*, *supra* note 13, at 58. *Roth Steel Tube Co. v. Commissioner* originally applied the eleven factors subsequently adopted for debt recharacterization purposes in the context of distinguishing debt from equity for tax loss reporting purposes. 800 F.2d 625, 630–32 (6th Cir. 1986).

³¹ *To & Siegel*, *supra* note 13, at 59 n.1 (noting four instances of recharacterization: *Diasonics Inc. v. Ingalls*, *In re Cold Harbor Assocs. L.P.*, *In re Georgetown Bldg. Assocs. L.P.*, and *In re Atlantic Rancher Inc.*). The fifth case is *Bunch v. J.M. Capital Finance, Ltd. (In re Hoffinger Indus., Inc.)*, 327 B.R. 389 (Bankr. E.D. Ark. 2005). Furthermore, "at least two of these cases involved what can fairly be called unusual facts. (In *Cold Harbor*, the court made the debt/equity call merely to help determine the number of claimholders for purposes of deciding whether a single creditor could file an involuntary

B. Code-Based Claim Avoidance Remedies

At the risk of adopting a too skeptical tone, debt recharacterization is a way for courts to approach potentially strategic actions by insiders. Recharacterization largely exists to deal with “shareholder contributions that are ambiguous in form.”³² Such ambiguity stems from the “natural inclination of the [insiders] of a floundering business [] to look in their own pockets . . . for cash to plug the leaks.”³³ Problems arise because the cash infusions are often described, but not treated, as loans—formal documentation or interest rate terms are missing, or payments simply are not made.³⁴ Such a situation:

makes it look as though the insider is trying to treat the contribution as a loan if the company performs either very well (and thus can repay it) or very poorly (winding up in bankruptcy), while treating it as a contribution to equity while the company’s finances remain in a precarious state.³⁵

Recharacterization is a doctrine suited to solve ambiguous loan problems that may or may not originate from an insider’s attempt at strategic behavior and that are left unaddressed by other Code based remedies.³⁶

First and foremost, judicial agreement on the power to recharacterize debt as equity notwithstanding, the Code expressly empowers debtors to use

petition under § 303(b), and in *Georgetown Building Associates*, the cash advances in question had been treated as capital contributions on the tax returns of the lenders themselves, and of the debtor, for six consecutive years.)” To & Siegel, *supra* note 13, at 58.

³² Skeel & Krause-Vilmar, *supra* note 17, at 267. Preferred shares issued by the company to the insider in exchange for funding are representative of the ambiguities between debt and equity, *see infra* note 176, but do not apply to problems of ambiguous loans. *See infra* notes 33–36 and accompanying text.

³³ Skeel & Kraus-Vilmar, *supra* note 17, at 268.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *See* David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 505–07 (“Courts are well equipped to detect strategic behavior, and the Bankruptcy Code is replete with provisions that put the court in this role. . . . To be sure . . . parties [can] invoke a variety of analogous nonbankruptcy statutory and common law rules as a means of policing strategic behavior . . .”). As I discuss in the following paragraphs, nonbankruptcy, common law, and Code “policing” provisions do not properly address problems posed by ambiguous insider loans, and therefore debt recharacterization is a necessary gap filler.

state law defenses to claims against the estate.³⁷ The Supreme Court holds that the determination of property rights in the assets of the bankrupt's estate is left to state law.³⁸ Accordingly, bankruptcy law embraces state laws governing the proper characterization of a claim as either debt or equity. It is therefore arguable that recharacterization exists as a power under the Code where state law allows such a remedy.³⁹

Nearly all recharacterization cases undertake a dual analysis of debt recharacterization and equitable subordination,⁴⁰ underscoring similarities between the two remedies,⁴¹ but noting that they address distinct issues.⁴²

³⁷ 11 U.S.C. § 544(b)(1) (2006) (“[T]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable *under applicable law* by a creditor holding an unsecured claim that is allowable under section 502”) (emphasis added); *see also* *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450 (2007) [hereinafter *Travelers*] (trustee has available “any defense available to the debtor under applicable *nonbankruptcy law*” (internal quotation marks omitted)).

³⁸ *Travelers*, 549 U.S. at 450–51; *see also* *Butner v. United States*, 440 U.S. 48, 56–58 (1979).

³⁹ *See* Wilton & Moeller-Sally, *supra* note 18, at 1268–80 (stating that using state law recharacterization standards leads to supporting capital markets “by restoring predictability in the enforcement of insider debt,” and resolves federal circuit court conflicts); Peretz, *supra* note 18, at 298.

⁴⁰ 11 U.S.C. § 510(c)(1) (“[A]fter notice and a hearing, the court may—(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest”). The law of equitable subordination is well-settled—three requirements exist for an equitable subordination claim: (1) inequitable conduct, (2) resulting in injury or unfair advantage to the claimant, and (3) equitable subordination would not be inconsistent with the Code. *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 699–700 (5th Cir. 1977) (compiling equitable subordination cases to establish elements of the remedy); *see also In re Lifschultz Fast Freight*, 132 F.3d 339, 344 (7th Cir. 1997). Two recent cases have reaffirmed the need for unsecured creditors to show harm to successfully challenge the claims of secured creditors under equitable subordination: *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355, 357 (5th Cir. 2008) and *In re Kreisler*, 546 F.3d 863, 866 (7th Cir. 2008).

⁴¹ *See* Skeel & Krause-Vilmar, *supra* note 17, at 266 (noting that the very codification of equitable subordination “raised questions about bankruptcy courts’ authority to recharacterize debt as equity”). Furthermore, the line between equitable subordination and recharacterization is certainly blurred. *See id.* at 267 (“[C]ourts’ sense of the propriety of the shareholder’s behavior seems to influence their decision whether to recharacterize.”). Shareholder (or, as I use in this Note, “Insider”) behavior is the quintessential inquiry in an equitable subordination analysis. *See infra* notes 42–45.

Equitable subordination is applicable when equity concerns call for a reordering of payment priority—the legitimacy of a creditor is not questioned, only its acts demand that other creditors take precedence.⁴³ “In contrast, the focus of a recharacterization inquiry is whether ‘a debt actually exists’”; in other words, recharacterization gets at the root of the transaction and essentially attaches a “proper characterization in the first instance of an investment.”⁴⁴ This fundamental difference leads courts to address debt recharacterization before equitable subordination, as doing otherwise would be equivalent to “taking the cart before the horse.”⁴⁵

The main difference in application between the two remedies is that no inequitable conduct is necessary to recharacterize a claim as an equity interest.⁴⁶ One can imagine a situation where a shareholder finances a struggling company’s acquisition of inventory, taking a security interest in the obtained items, yet never requiring repayment. Should the company’s hard times not be solved by the infusion, it enters bankruptcy. Suppose a creditor ends up unhappy with its prospects in bankruptcy, partially due to the shareholder’s “claim.” Arguably, the shareholder engaged in a perfectly reasonable transaction with the company. A creditor’s opportunity to challenge such a situation to improve its own financial return out of the debtor’s estate relies upon a court deeming the shareholder’s infusion of funds to be an equity contribution, thereby eliminating the shareholder’s relative priority. However, challenging the transaction on grounds of equitable subordination would not be a successful option. Recharacterization instead looks to the transaction’s objective criteria, ignoring form in favor of true substance, which might in this case result in an equity characterization.⁴⁷ Malfeasance is not an issue. Because debt recharacterization is applicable,

⁴² *Submicron Sys.*, 432 F.3d at 454 (“Yet recharacterization and equitable subordination address distinct concerns.”). Recharacterization differs significantly by looking “through a transaction labeled as a loan (debt) and instead [characterizing] it based on its economic substance as an equity contribution.” *Klee & Mervis*, *supra* note 18, at 213.

⁴³ *Submicron Sys.*, 432 F.3d at 454.

⁴⁴ *Id.*

⁴⁵ *Id.* at 455 (internal quotation marks omitted) (quoting *Diasonics, Inc. v. Ingalls*, 121 B.R. 626, 630 (Bankr. N.D. Fla. 1990)).

⁴⁶ *Bayer, Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726, 748 (6th Cir. 2001).

⁴⁷ *Sender v. Bronze Group, Ltd., (In re Hedged-Invs.Assocs.)*, 380 F.3d 1292, 1297 (10th Cir. 2004).

inter alia, to transactions devoid of inequitable conduct, it is a distinct remedy.⁴⁸

The result of recharacterization also differs from explicit Code-based remedies, and other options traditionally available for creditors to challenge the claims of other parties to a debtor's estate. Recharacterization imposes an absolute subordination of the entirety of a claim; indeed, debt recharacterization has a "draconian effect . . . on the rights of the lenders involved."⁴⁹ Therefore, rather than merely subordinating the claim, a loan subject to debt recharacterization essentially changes form to an equity interest and is placed in an entirely different class of rights against the debtor.⁵⁰ Therefore, equitable subordination is inapposite to recharacterization, regarding both judicial inquiry and remedy imposed.

In addition to equitable subordination, fraudulent conveyance law is a Code-based remedy that allows trustees to avoid debtor transfers or obligations incurred within two years of filing a bankruptcy petition.⁵¹

⁴⁸ But see *infra* Part IV.A (discussing inconsistent treatment by courts of whether inequitable conduct is required for debt recharacterization).

⁴⁹ To & Siegel, *supra* note 13, at 59.

⁵⁰ See, e.g., 2E Bankr. Service L. Ed. § 25:357, Interests Not Amenable to Equitable Subordination ("If a particular advance is a capital contribution rather than a debt, then there is no need to consider whether claim for that advance should be equitably subordinated to claims of other creditors.").

⁵¹ 11 U.S.C. § 548 (2006):

The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—(A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or (B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

State fraudulent conveyance law supplements the Code's fraudulent conveyance requirements and limitations. See *In re Revco D.S., Inc.*, 118 B.R. 468, 474 (Bankr. N.D. Ohio 1990); *supra* notes 33–35 and accompanying text.

However, fraudulent conveyance law is inapt to a recharacterization analysis because the challenge in a recharacterization action is against the insider's contribution, rather than consideration issued in exchange for a debtor's transfer. The Bankruptcy Code adopted Section 548 to allow a debtor's creditors to combat either constructive or actual fraud that may result from a debtor's attempts to transfer assets to the detriment of such existing creditors.⁵²

The Code's voidable preference law⁵³ intends to protect creditors by cancelling a debtor's eve of bankruptcy transfers to creditors that disproportionately benefit that creditor and defeat the Code's underlying policy of pooling the debtor's assets for equal distribution according to the Code's strict priority scheme.⁵⁴ Therefore, preference law addresses whether payments actually made to a creditor within a 90-day time period prior to bankruptcy are to be returned to the debtor's estate. In contrast, recharacterization pertains to classifying the priority level of a transaction between a party and the debtor.

Debtors in bankruptcy, including directors and officers, owe fiduciary duties to creditors.⁵⁵ Therefore, the voluminous fiduciary duty case law in the United States also applies in bankruptcy to protect creditors and others with claims against, or interests in, the debtor. Furthermore, the veil piercing doctrine may be used to remedy abuses of the corporate form, such as fraud, or where adhering to the corporate form would create inequitable results.⁵⁶ The occurrence of bankruptcy does not prevent courts from stepping in to prevent or remedy an abuse of the corporate form.⁵⁷

⁵² See Skeel & Krause-Vilmar, *supra* note 17, at 261. Professor Clark proposed that fraudulent conveyance law was the stimulus for other creditor protections in the Code and under nonbankruptcy law that developed to fill the cracks left by "transaction-specific requirements of fraudulent conveyance law." *Id.* at 261–62 (citing Clark, *supra* note 17, at 509–13).

⁵³ 11 U.S.C. § 547 (2006).

⁵⁴ See H.R. REP. NO. 95-595, at 177–78 (1977) (two underlying policies of preference law are discouraging creditors from "racing to the courthouse to dismember the debtor during his slide into bankruptcy," thereby promoting the debtor's cooperation with all creditors, and ensuring equality of distribution of the debtor's estate among its creditors).

⁵⁵ Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

⁵⁶ See 2 JAMES D. COX & THOMAS LEE HAZEN, COX AND HAZEN ON CORPORATIONS § 7.08 (2d ed. 2003).

⁵⁷ *Id.*; see also *supra* notes 35–37 & accompanying text.

III. TWO RECENT CASES: *DORNIER AVIATION* AND *SUBMICRON SYSTEMS*

This Part will discuss a 2006 Fourth Circuit case⁵⁸ and a 2006 Third Circuit case⁵⁹ analyzing recharacterization claims against insider transactions. The Fourth Circuit in *Dornier Aviation* became the first circuit to actually act on its stated power of recharacterization, classifying a parent airplane manufacturer's (Fairchild) parts transactions with its subsidiary (DANA) as equity when the subsidiary found itself in bankruptcy. The Third Circuit in *Submicron Systems* determined that corporate insider contributions to the debtor's major lender to ensure continued loan extensions were not equity transactions, therefore denying the creditor committee's recharacterization claim. The ultimate inquiries of the two circuits are inconsistent with each other. The inconsistency exacerbates the notice problem posed by current debt recharacterization tests.

A. Dornier Aviation

The portion of the *Dornier Aviation* bankruptcy proceeding relevant to this Note involves Fairchild's \$90 million claim for transactions with DANA regarding aircraft manufacturing parts, i.e. intercompany trade debt.⁶⁰ The issue was whether trade credits extended by the parent, Fairchild (a German aircraft manufacturer), to the debtor (DANA), were capital contributions constituting equity. DANA was found to be under-capitalized—its financials immediately preceding the bankruptcy filing consisted of \$50,000 of equity and nearly \$50 million of negative accumulated earnings and profits and shareholder equity—and as a 100% shareholder of DANA, Fairchild was an insider of the debtor.⁶¹

Fairchild did not require DANA to pay for the parts transactions until DANA became profitable—Fairchild treated DANA as an investment, according to the Chief Financial Officer.⁶² The Official Committee of Unsecured Creditors (Committee) sought to have Fairchild's \$90 million claim reduced to reflect the amount owed by DANA as determined by an

⁵⁸ *Dornier Aviation*, 453 F.3d 225.

⁵⁹ *Submicron Sys.*, 432 F.3d 448.

⁶⁰ Official Comm. of Unsecured Creditors v. Fairchild Dornier GMBH (*In re Dornier Aviation* (N. Am.) Inc.), No. 02-82003-SSM, 2005 WL 4781236, at *21 (Bankr. E.D. Va. 2005) [hereinafter *In re Dornier Aviation*].

⁶¹ *Id.* at *2.

⁶² *Id.* at *5. The stated purpose for such treatment was to allow DANA to establish its business and services. *Id.*

independent audit report (about \$28 million), and recharacterized as equity.⁶³ The court ultimately held that \$84 million of the claim was equity, and \$6 million constituted debt. The \$84 million portion of Fairchild's claim was therefore recharacterized.⁶⁴

The Bankruptcy Court for the Eastern District of Virginia first stated that the Committee had not carried its burden of proof under Section 510(c)(1) to establish equitable subordination of Fairchild's claim.⁶⁵ Even though Fairchild was an insider of DANA, and DANA was under-capitalized at the time of the transactions, the Committee had not shown unfair conduct justifying equitable subordination of an otherwise valid claim.⁶⁶

The court then listed recharacterization tests from the Fifth, Sixth, and Tenth Circuits.⁶⁷ These tests narrowed down to an inquiry of whether there was proof of under-capitalization and if the loan was made when no other disinterested lender would have extended credit.⁶⁸ The court ultimately found the lack of a fixed maturity date and "the hope of payment out of future profits," to be "exactly what characterizes an equity investor."⁶⁹ Formal instruments evidencing the "claim" and accrual of interest on the "loan" could not save Fairchild from debt recharacterization.

The Fourth Circuit affirmed the bankruptcy court, finding that bankruptcy courts must be empowered to resolve characterization disputes to facilitate the Code's payment hierarchy under Section 726(a).⁷⁰ The court

⁶³ Brief of Appellee at 46, *Dornier Aviation*, No. 05-1930 (4th Cir. Nov. 23, 2005).

⁶⁴ *In re Dornier Aviation*, 2005 WL 4781236 at *21.

⁶⁵ *Id.* at *17.

⁶⁶ *Id.*

⁶⁷ *Id.* at *18–19.

⁶⁸ See *In re N&D Props.*, 799 F.2d at 733; *Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners, L.P.)*, 200 B.R. 996 (Bankr. N.D. Ill. 1996).

⁶⁹ *In re Dornier Aviation*, 2005 WL 4781236 at *19.

⁷⁰ *Dornier Aviation*, 453 F.3d at 233 (power of recharacterization "is integral to the consistent application of the Bankruptcy Code"). Section 105(a) authorizes bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). Therefore, bankruptcy courts may recharacterize claims to effectuate Section 726(a), whereby equity holders' recoveries are subordinated to claims of secured and unsecured creditors. *Id.* § 726(a):

Except as provided in section 510 of this title, property of the estate shall be distributed—

[first according to section 507, second to allowed unsecured claims, third to tardily filed unsecured claims, fourth to any allowed claim for fine, penalty, or forfeiture, or punitive damages to the extent that the claim is not compensation for actual

looked at multi-factor balancing tests from the Sixth⁷¹ and Tenth Circuits (finding them substantially similar⁷²) to determine whether the transaction reflected the characteristics of an arm's length negotiation. In finding the transactions "on the whole . . . more consistent with a capital contribution," the Fourth Circuit in *Dornier Aviation* affirmed the bankruptcy court's decision that the significant aspects at issue were:

(1) [the parent's] insider status, (2) 'the lack of a fixed maturity date' for the purported loan, (3) the fact that [the debtor] would not be required to pay until it became profitable, (4) [the debtor's] 'long history of unprofitability and the fact that its liabilities after the corporate restructuring far exceeded its assets,' and (5) [the parent's] assumption of [the debtor's] losses.⁷³

In effect, "the substance of the relationship represented a capital contribution designed to prop up the struggling subsidiary."⁷⁴ The bankruptcy court's explanation of why, on balance, the transactions evidenced equity rather than debt focused on "the lack of a fixed maturity date," that "payment would be made only when [the debtor] became profitable," the lack of evidence that the debtor could obtain third party financing because of a history of unprofitability and liabilities far exceeding assets.⁷⁵

In *Dornier Aviation*, "whether the transaction bears the earmarks of an arm's-length bargain" is the quintessential starting point for recharacterizing

pecuniary loss, fifth for interest payments on any claim previously allowed by this section, and]

sixth, to the debtor.

⁷¹ The eleven *In re Autostyle Plastics* factors are:

(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate or interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

Bayer, Corp. v. MascoTech, Inc. (*In re Autostyle Plastics, Inc.*), 269 F.3d 726, 749–50 (6th. Cir. 2001).

⁷² *Dornier Aviation*, 453 F.3d at 234 n.6.

⁷³ *Id.* at 234.

⁷⁴ *Id.* at 235.

⁷⁵ *In re Dornier Aviation*, 2005 WL 4781236 at *19.

a claim as equity.⁷⁶ The “arm’s-length bargain” inquiry boiled down to the debtor’s financial weaknesses, causing the court to deem it an unattractive borrower. While the court was sure to note that undercapitalization and insider status of a claimant is insufficient to support recharacterization,⁷⁷ such factors provided the foundation for upholding the bankruptcy court’s decision recharacterizing Fairchild’s claims against the debtor’s estate as equity contributions.

B. Submicron Systems

The Third Circuit’s recent decision regarding debt recharacterization attempted to extract the intent of the parties to a challenged transaction.⁷⁸ In *Submicron Systems*, the defendant insiders extended loans to protect their prior investments in the debtor. They argued in part that had funding not been provided, the debtor would have been liquidated.⁷⁹ Therefore, self-interest compelled the extension of funding: “[w]hen a company is in distress, the only parties motivated to put new money in are those that already have a financial stake.”⁸⁰ The bankruptcy court accepted this reasoning and held that it was “beyond dispute in the record that . . . the intent of the parties was to create debt.”⁸¹

Accordingly, the Third Circuit stated that the various tests put forward by courts in recharacterization cases “devolve to an overarching inquiry: the

⁷⁶ *Id.*; see also *In re Autostyle Plastics, Inc.*, 269 F.3d at 749–50 (the eleven factors all indicate whether the transaction “appears to reflect the characteristics of . . . an arm’s length negotiation”); *In re Cold Harbor*, 204 B.R. at 915.

⁷⁷ *Dornier Aviation*, 453 F.3d at 234.

⁷⁸ *In re Submicron Sys. Corp.*, 291 B.R. 314 (Bankr. D. Del. 2003) [hereinafter *In re Submicron Sys.*].

⁷⁹ *Id.* at 324–25.

⁸⁰ *Id.* at 325.

⁸¹ *Id.* *In re Submicron Systems* used seven factors from a 2000 case in the same court deciding whether a security was equity or debt by looking to the contract existing between the corporation and those holding securities. *Id.* at 323 (citing Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Blackstone Family Inv. P’ship (*In re Color Tile, Inc.*), 2000 WL 152129 (D. Del. 2000)). The seven factors used were:

(1) the name given to the instrument; (2) the intent of the parties; (3) the presence or absence of a fixed maturity date; (4) the right to enforce payment of principal and interest; (5) the presence or absence of voting rights; (6) the status of the contribution in relation to regular corporate contributors; and (7) certainty of payment in the event of the corporation’s insolvency or liquidation.

Id.

characterization as debt or equity is a court's attempt to discern whether the parties called an instrument one thing when in fact they *intended* it as something else.”⁸² Such intentions are exposed by inquiring whether the lending party expected to be repaid regardless of the borrower's fortunes, or subject to the borrower's fortunes.⁸³ However, affirming the lower court's factual findings to refuse the claim for recharacterization, the Third Circuit's opinion of “ample evidence” to support a debt characterization was rooted in form: the funding was named “debt,” it had a fixed maturity date and called for fixed interest, and the notes evidencing the debt were recorded as secured debt.⁸⁴ Notably, the bankruptcy court's findings that even though the debtor was severely undercapitalized and insolvent, and that no disinterested third party lender would have advanced financing to the debtor, were not sufficient to overcome the indicators of debt previously mentioned.⁸⁵ It is difficult to avoid the conclusion that the Third Circuit's inquiry into “intent” was based on form.

C. *Conclusions on Dornier Aviation and Submicron Systems*

Courts considering recharacterization cases use about a dozen different factors when deciding whether to recharacterize debt as equity. The factors are intended to uncover the true substance of a claimant's transaction with the debtor. The two decisions discussed above shed light on the true substance behind the multi-factor inquiries: party characterization is trumped by objective inquiries into the quality of the borrower, or the intent of the parties to the transaction is the decisive consideration.

These inquiries are inconsistent and flawed. Eleven or thirteen factor tests, with no dispositive factor, are necessarily ambiguous and are too vague to properly alert current and potential lenders of whether a bankruptcy court

⁸² *Submicron Sys.*, 432 F.3d at 456 (emphasis added).

⁸³ *Id.* (the former indicates debt and the latter indicates equity); see also *In re St. Charles Pres. Investors, Ltd.*, 112 B.R. 469, 474 (D.D.C. 1990) (limited partners treated as creditors of debtor due to right to receive interest “*regardless of the debtor's earnings or profits*”). The court also noted that the partners' additional right to receive a percentage of earnings and profits represented an equity interest and not a debt. *Id.*

⁸⁴ *Submicron Sys.*, 432 F.3d at 457.

⁸⁵ *In re Submicron Sys.*, 291 B.R. at 323. The court held that the plaintiff challenging the transactions at issue as equity “failed to prove that under [the debtor's] dire circumstances, defendants' transactions were improper or unusual.” *Id.* at 325. In so holding, the court accepted the defendants' expert testimony that existing lenders extending loans to distressed companies do not apply traditional factors such as “capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios” as they would when lending to a financially stable company. *Id.*

will respect the label attached to a particular transaction. The “creditor” in *Dornier Aviation* abided by formalities, imposed a commercially reasonable interest rate,⁸⁶ intended to be repaid,⁸⁷ and had an independent auditor examine the transactions⁸⁸ (concluding that a “debt” did indeed exist). Nonetheless, Fairchild’s insider status, lack of a fixed maturity date, delayed payments until the debtor became profitable, and the debtor’s liabilities exceeding its assets, established the equity characterization.⁸⁹

Where a sizeable number of factors in a non-exclusive and disjunctive test weigh in favor of both debt and equity, parties can only be left with the conclusion that courts are acting on what they believe to be the equitable result. The broad array of factors used in debt recharacterization balancing tests inevitably results in judges making subjective decisions.⁹⁰ Bankruptcy and circuit courts therefore apply non-uniform standards. Furthermore, the Fourth Circuit’s reliance on Fairchild’s intent to be repaid out of DANA’s profits is also indicative of courts saying they look to the objective indicia of an arm’s length negotiation, yet actually recharacterizing debt on the basis of intent. The distilled inquiries resulting from multi-factor tests applied by the Fourth and Third Circuits remain inconclusive.

One of the most disconcerting aspects of *Dornier Aviation* is the fact that Fairchild acted as a supplier to its debtor, DANA, yet had its legitimate transactions recharacterized as capital contributions. When Fairchild sold aircraft to customers, the aircraft were covered by a warranty, and the buyers had the option to purchase a set of provisional parts.⁹¹ DANA issued the warranties and sold the provisional parts packages. DANA was charged above cost for the parts packages it purchased from Fairchild.⁹² Fairchild did not immediately seek payment for the transactions; instead, Fairchild allowed DANA opportunity to become profitable before requiring reimbursement.⁹³

The commercial reasonableness of this interaction is hard to question. Extensions of credit occur precisely to account for situations where the debtor is unable to immediately afford the needed items. Also, as respected

⁸⁶ *In re Dornier Aviation*, 2005 WL 4781236 at *8.

⁸⁷ *Id.* at *5.

⁸⁸ *Id.* at *9–11.

⁸⁹ *Dornier Aviation*, 453 F.3d at 234.

⁹⁰ Hilary A. Goehausen, *You Said You Were Going to Do What to My Loan? The Inequitable Doctrine of Recharacterization*, 4 DEPAUL BUS. & COM. L.J. 117, 128 (2005).

⁹¹ *In re Dornier Aviation*, 2005 WL 4781236 at *4–5.

⁹² *Id.* at *4.

⁹³ *Id.* at *4–5.

by the Third Circuit in *Submicron Systems*, creditors will often seek to protect their earlier extensions of funds by providing bridge loans to get a debtor through hard times.⁹⁴ Circuit courts are rarely, if ever, presented with pleas for debt recharacterization of outside creditor loans.⁹⁵ Therefore, it seems that the parent/subsidiary relationship in *Dornier Aviation* was more important to the court's decision than it let on. *Dornier Aviation* essentially encourages creditor committees and trustees in bankruptcy to immediately challenge any extension of funding by a corporate insider. This is inconsistent with the Third Circuit's implicit holding in *Submicron Systems* that having appropriate loan formalities is the prevailing inquiry in debt recharacterization. The contradictions between circuits, as well as within an individual case, make the need for new debt recharacterization tests all the more apparent.

IV. PROBLEMS WITH THE CURRENT ANALYSIS

Recharacterization is an important option for challenging insider loans as equity.⁹⁶ Insiders, probably more than other parties with an interest in or claim against the debtor, have an incentive to disguise an equity contribution as a loan—they protect their sweat equity, prior investment, and business vision by providing funding to step back from the edge of insolvency, and gain priority relative to equity holders in bankruptcy if the transaction is respected as a loan.⁹⁷ Arguably, and understandably, insiders would like to have their cake and eat it too—maintain the viability of past investments, and receive the benefits, but not the risks, of equity. However, notwithstanding

⁹⁴ See also *In re Atl. Rancher, Inc.*, 279 B.R. 411, 411 (Bankr. D. Mass. 2002).

⁹⁵ See *supra* note 2.

⁹⁶ See *supra* Part II; see also Georgette Chapman Poindexter, *Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing*, 2 BERKELEY BUS. L.J. 233, 251 (2005) ("It is because of its flexibility that recharacterization is a more powerful tool than equitable subordination."). Professor Poindexter also notes that the "very flexibility [of recharacterization] . . . is a double-edged sword for creditors." *Id.* at 252.

⁹⁷ See Skeel & Krause-Vilmar, *supra* note 17, at 272 ("To be sure, shareholder managers . . . tend to view [the business] through the rosier of glasses. They also have a huge human capital investment in the company. The shareholder's decision to make a loan therefore may be anything by objective."). Furthermore, a shareholder loan may prevent creditors from taking actions into their own hands and throwing the debtor into bankruptcy involuntarily. *Id.* at 270; 11 U.S.C. § 303 (2006). However, creditors involuntarily commencing a Chapter 11 or Chapter 7 case against the debtor must show that the "debtor is generally not paying [its] debts as such debts become due . . ." *Id.* § 303(h)(1). The insider's loan very well may enable the company to pay its creditors and avoid the involuntary case.

this potential for manipulation, Congress determined more than thirty years ago when it enacted equitable subordination in the Code that insider loans were not to be automatically subordinated in bankruptcy.⁹⁸ Such a decision is conclusive of the need to properly critique insider loans.

However, the factors courts use to get at the true substance of a loan through debt recharacterization can be greatly improved to more accurately represent the appropriate label of an insider's debt or equity transaction, and provide notice to potential insider lenders about what will constitute a loan in a judge's eyes. Regardless of judicial hesitation to actually apply the doctrine,⁹⁹ the inconclusive nature of debt recharacterization analyses and the substantive inquiries courts undertake work a disservice on the success of small and medium sized businesses.¹⁰⁰ Insider transactions supporting an otherwise healthy company struggling from current general economic malaise are not encouraged by debt recharacterization's inquiry into numerous generic objective indicia of debt or equity. As *Dornier Aviation* and *Submicron Systems* represent, even the elaborate arm's length negotiation test, and the amorphous "intent of the parties to the transaction" test, are not exclusive.¹⁰¹

This Note does not intend to criticize courts for inadequate attention to the dilemma of insider loan characterization. Without fail courts approach the issue with exhaustive factual analysis. Furthermore, it is clear that bankruptcy courts are "adept at dealing with classifications of either debt or equity."¹⁰² However, "[w]here it becomes difficult is classifying a claim that has attributes of both debt and equity."¹⁰³ Courts are firmly grounded in precedent under the wide reaching understanding of *stare decisis*, which, in the debt recharacterization analysis, unfortunately results in a misplaced

⁹⁸ See Report of the Comm. on the Bankr. Laws of the U.S., H.R. DOC. NO. 93-137, pt. 2, at 115 (1973). Congress codified equitable subordination in 1978 when reforming the bankruptcy laws. The committee submitting the reforms suggested automatic subordination of insider claims to the bankrupt's estate. Such provision was not, however, included in the final legislation. Skeel & Krause-Vilmar, *supra* note 17, at 265-66, 273, 284 (arguing for automatic disallowance of shareholder security interests, treating the same as unsecured claims because "secured shareholder loans so often and so thoroughly" hinder creditors).

⁹⁹ See *supra* Part II. notes 29-31 and accompanying text.

¹⁰⁰ See Skeel & Krause-Vilmar, *supra* note 17, at 270 ("[R]eal world of financially troubled companies" that "figure in many of the recharacterization cases" consists particularly of "small- and medium-sized businesses.").

¹⁰¹ See *supra* Part III.C.

¹⁰² Poindexter, *supra* note 96, at 248.

¹⁰³ *Id.*

focus. Bankruptcy, district, and circuit courts alike have largely decided that the difficult distinction between “blurred” debt and equity in the context of an insider transaction is to be made primarily on four factors: an insider’s inequitable conduct, whether the debtor was adequately capitalized, the debtor’s creditworthiness, and the insider’s decision to secure the loan.¹⁰⁴ Unfortunately, the inquiries are inapt, giving credence to issues out of precedent rather than commercial reasonableness. Adequate capitalization, creditworthiness, and presence of security are particularly worrisome factors given today’s tight economic climate.

A. Inequitable Conduct

Courts should summarily dismiss inequitable conduct as a relevant debt recharacterization inquiry.¹⁰⁵ While not specifically enumerated in the multiple factor tests used to make a recharacterization determination,¹⁰⁶ courts nevertheless use inequitable conduct as a proxy for recharacterizing debt as equity.¹⁰⁷ In other words, inequitable conduct makes it easier for a

¹⁰⁴ Brighton, *supra* note 14, at 42 (factors courts typically consider “fall into three critical groups: (1) the formality of the alleged loan agreement, (2) the financial situation of the company when the creditor made the purported loan and (3) the relationship between the creditor and the debtor”).

¹⁰⁵ Indeed, some courts and practitioners assert that debt recharacterization does not require inequitable conduct. *In re Autostyle Plastics*, 269 F.3d at 748–49; James H.M. Sprayregen et al., *Recharacterization from Debt to Equity: Do Bankruptcy Courts Have the Power?*, 19 No. 5 BANKR. STRATEGIST 1 (2002).

¹⁰⁶ See discussion *supra* note 71.

¹⁰⁷ See *In re Zenith Elec. Corp.*, 241 B.R. 92, 107 (Bankr. D. Del. 1999) (requiring inequitable conduct for debt to equity recharacterization); *Anderson v. A.F. Walker & Son, Inc.* (*In re A. F. Walker & Son, Inc.*), 46 B.R. 186, 189–90 (Bankr. D.N.H. 1985) (“Courts do continue to talk however in terms of requiring a showing of actual misconduct on the part of the insider without explaining whether an ‘unfair advantage’ . . . is or is not equivalent to their concept of the required misconduct.”); see also Robert J. Graves, *Loans to “Insiders”: How to Avoid Recharacterization in Bankruptcy*, 3 BANKING L. REV. 18, 22–23 (1990). In recharacterizing a lessor’s claim against the debtor as a capital contribution, the court established a standard regarding inequitable conduct:

For insider dealings to be characterized and set aside as capital contributions, it must be established: (1) that the transactions lacked the earmarks of an arm’s length bargain, and (2) that it was for the purpose of engaging in some type of inequitable conduct that resulted in either injury to arm’s length creditors or unfair advantage to the insider.

Id. (citing *In re LaBelle Indus., Inc.*, 44 B.R. 760 (Bankr. D.R.I. 1984)); *Rego Crescent Corp. v. Tymon* (*In re Rego Crescent Corp.*), 23 B.R. 958, 965 (Bankr. E.D.N.Y. 1982)

court to justify such a "draconian"¹⁰⁸ action. Inequitable conduct overlaps application of the doctrine of equitable subordination, causing confusion between the two similar doctrines. Furthermore, inequitable conduct is unnecessary for a claim to be recharacterized as equity—recharacterization's purpose is to accurately reflect the nature of the transaction, a purpose separate from passing judgment on good or bad faith conduct. Finally, a party aggrieved by an insider's inequitable conduct may use equitable subordination to remedy any harm incurred.

To begin, Congress codified equitable subordination in 1978, leaving to courts development of the principle.¹⁰⁹ Subsequent Supreme Court and circuit court decisions established inequitable conduct as a necessary element for equitable subordination of a claim against the debtor's estate.¹¹⁰ Its inclusion in a debt recharacterization analysis results in confusion of the two different remedies.¹¹¹

Furthermore, where a statutory remedy already exists, bankruptcy courts must not use their equitable power to achieve the same result of the pre-existing and codified remedy through a different method. The Ninth Circuit's Bankruptcy Appellate Panel has outright rejected the viability of the doctrine of recharacterization for this reason.¹¹² *Pacific Express* held that because recharacterization accomplishes the same result as equitable subordination through different means, recharacterization contradicts congressional intent

("[I]n many cases where the courts have subordinated debts arising from insider loans there has been some inequitable conduct . . .").

¹⁰⁸ To & Siegel, *supra* note 13, at 59.

¹⁰⁹ H.R. REP. NO. 98-882, at 576 (1984) (Conf. Rep.).

¹¹⁰ See *United States v. Noland*, 517 U.S. 535 (1996) (inequitable conduct necessary for application of equitable subordination); *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986-87 (3d Cir. 1998) (equitable subordination requires that "the claimant must have engaged in some type of inequitable conduct"); see also cases cited *supra* note 40.

¹¹¹ See *In re 200 Woodbury Realty Trust*, 99 B.R. 184, 188 n.4 (Bankr. D.N.H. 1989) (in context of attack against insider's transaction with an undercapitalized debtor, "it seemed to [the court] that actual misconduct was not a necessary element [to recharacterization]—although this court may be the only court so noting the distinction") (emphasis added). To be sure, such confusion has been cleaned up. See *In re Atlanticrancher*, 279 B.R. at 433 (compiling cases and noting that "once considered solely in conjunction with the doctrine of equitable subordination, bankruptcy courts now consider recharacterization a separate cause of action").

¹¹² *In re Pac. Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986) [hereinafter *Pac. Express*] (holding that the Code does not provide a basis to recharacterize debt as equity); accord *Pinetree Partners, Ltd. V. OTR (In re Pinetree Partners, Ltd.)*, 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988).

because Congress explicitly provided a remedy to confront inequitable conduct in particular.¹¹³ Congress's intent by providing for equitable subordination through Section 510(c)(1), is arguably defeated by making a judicially crafted addition to the statutory scheme.

Providing challengers of an insider's claim against the debtor a second remedy with similar burdens to satisfy,¹¹⁴ yet resulting in complete priority subordination in bankruptcy,¹¹⁵ accomplishes an undesirable result: discouraging insider debt-finance assistance to a struggling company by providing claim challengers a remedy "grab bag" with different severities and burdens that do not perfectly align.¹¹⁶ *Dornier Aviation* is illustrative of this non-alignment.¹¹⁷ The Fourth Circuit in *Dornier Aviation* avoided the temptation to recharacterize an entire claim as equity, holding that about \$6 million (out of an original claim of about \$90 million) of the parent "creditor's" claim would remain characterized as debt. In so doing, the Fourth Circuit avoided a common concern among recharacterization opponents—the inequity of converting an entire claim to an equity interest,

¹¹³ *Pac. Express*, 69 B.R. at 115. The Ninth Circuit's opinion stressed the fact that courts do not have the power to achieve the same result as a codified remedy "under different standards through the use of the court's equitable powers." *Id.* The Bankruptcy Court for the Western District of Wisconsin held that the recharacterization of a claim as an equity interest is never an appropriate exercise of a bankruptcy court's power because Section 510(c) provides a framework for subordinating claims, and using Section 105(a) to recharacterize claims to achieve the same result circumvents that framework. *In re Airadigm Commc'ns, Inc.*, 376 B.R. 903, 913 (W.D. Wis. 2007). Tracking the language of Section 510(c), claims are to be subordinated only to other claims, not "into the lower tier of interests"—recharacterizing a claim as equity therefore contradicts Congress's explicit language. *Id.*; accord *Blasbalg v. Tarro (In re Hyperion Enters., Inc.)*, 158 B.R. 555, 561 (Bankr. D.R.I. 1993) ("In providing that claims may be subordinated to claims and interests to interests, section 510(c) does not authorize recasting of a claim as an interest.").

¹¹⁴ *But cf. Poindexter*, *supra* note 96, at 251 ("[T]he stiffer requirements of equitable subordination need not be met" in a recharacterization case). Professor Poindexter's recharacterization analysis holds that the inequitable conduct requirement of equitable subordination, in the form of fraud, illegality, breach of fiduciary duty, and undercapitalization cases, is not required for debt recharacterization, and judicial equitable powers to order debt recharacterization reinforces this greater leniency. *Id.*

¹¹⁵ *Sprayregen*, *supra* note 105, at 1 ("[E]quitable subordination results in lower-priority claim debt, whereas recharacterization converts a creditor's claim to an equity interest.").

¹¹⁶ Debt recharacterization results in more severe subordination (a change in class from "claim" to "interest") with a less burdensome showing required for the debt recharacterization claimant.

¹¹⁷ *Dornier Aviation*, 453 F.3d at 234.

relegating it entirely to the end of the bankruptcy repayment line. Such blanket subordination is arguably a more severe form of equitable subordination,¹¹⁸ without the attendant proof requirements of unfair or inequitable conduct.¹¹⁹

Finally, the inapplicability of equitable or inequitable conduct to determining either if the objective indicia of the transaction evidence an arm's length negotiation—as in *Dornier Aviation*—or whether the intent of the parties to the transaction was to create a debt—as in *Submicron Systems*—should result in this inquiry being trashed. The recharacterization inquiry takes place before a court will address equitable subordination.¹²⁰ “Claims” remain “claims” even when equitably subordinated. However, if a “claim” is recharacterized as “equity,” then by definition such an interest is not a “claim.”¹²¹ Therefore, the threshold inquiry is determining whether a transaction represents a “claim.” Equitable conduct has no bearing on this determination.

B. Inadequate (or Under) Capitalization

In determining adequate capitalization¹²², both in the debt recharacterization context and otherwise, courts look to the debt/equity ratio of a particular company.¹²³ Such courts often look to the adequacy of capitalization *at the time of* the challenged transaction.¹²⁴ The purpose of

¹¹⁸ To & Siegel call this a “*sub rosa* attempt at equitable subordination.” To & Siegel, *supra* note 13, at 58.

¹¹⁹ Wilton & Moeller-Sally, *supra* note 18, at 1257 (“[A] cause of action in federal court for debt recharacterization can be easier to prove than an action for equitable subordination.”).

¹²⁰ See *supra* Part II.B.

¹²¹ 11 U.S.C. § 101(5), (16) (2006).

¹²² See Ronald R. Sussman & Michael A. Klien, *Recharacterization Battles Likely in Next Round of Bankruptcies*, J. CORP. RENEWAL (Oct. 2008), available at <http://www.cooley.com/58842> (follow “VIEW ARTICLE” hyperlink) (arguing that courts should primarily look to a debtor’s adequate capitalization and creditworthiness in a debt recharacterization analysis to “ease the evidentiary burden on unsecured creditors”).

¹²³ See *Roth Steel Tube Co.*, 800 F.2d at 630 (debt to equity ratio of 300-to-1 at time of transaction indicative of capital and not loan); *Bauer v. Comm’r*, 748 F.2d 1365, 1369 (9th Cir. 1984) (debt to equity ratio determined by tax court was 92-to-1, indicating contribution to risk capital, found unsupported by Ninth Circuit, which found a debt to equity ratio between 2-to-1 and 8-to-1).

¹²⁴ *In re Autostyle Plastics*, 269 F.3d at 751 (debt recharacterization context); *Roth Steel Tube Co.*, 800 F.2d at 630 (characterization for tax purposes); *Fruehauf Corp. v.*

such an inquiry is to determine the debtor company's ability to repay the "loan"¹²⁵—a higher debt/equity ratio being indicative of an equity transaction due to the higher risk that a business loss would result in non-payment of the "loan."¹²⁶ In debt recharacterization, however, the emphasis on undercapitalization is unhelpful as "a company's financial condition is not always a good barometer of whether a loan is justified."¹²⁷

If relevant at all, the inquiry is meaningful only with respect to loans extended contemporaneously with *initial* inadequate capitalization.¹²⁸ Indeed, a Massachusetts superior court has stated that: "Re-characterization of debt as equity is intended to protect creditors dealing with a newly formed business that is grossly undercapitalized at its inception."¹²⁹ Courts need to be clear, however, that mere initial undercapitalization does not carry-over to recharacterize loans extended at a time of subsequent capitalization. Post-inception undercapitalization should not be sufficient to encourage debt recharacterization.¹³⁰ Subsequent capitalization fluctuates and where a

Revitz (*In re Transystems Inc.*), 569 F.2d 1364, 1369–71 (5th Cir. 1978) (funds advanced by parent to subsidiary prior to bankruptcy challenged as capital contributions); *Estate of Nixon v. United States*, 464 F.2d 394, 408–409 (5th Cir. 1972) (cause of action for tax refund).

¹²⁵ *Gilbert v. Comm'r*, 248 F.2d 399, 407 (2d Cir. 1957).

¹²⁶ *Bauer*, 748 F.2d at 1369.

¹²⁷ *Skeel & Krause-Vilmar*, *supra* note 17, at 278.

¹²⁸ *In re N&D Props., Inc.*, 799 F.2d at 733 (debt recharacterization appropriate only where trustee proves initial undercapitalization or there is no other disinterested lender willing to extend credit); see also Stephen B. Presser, *The Bogalusa Explosion*, "Single Business Enterprise," "Alter Ego," and Other Errors: *Academics, Economics, Democracy, and Shareholder Limited Liability: Back Towards a Unitary "Abuse" Theory of Piercing the Corporate Veil*, 100 NW. U. L. REV. 405, 421 n.76 (2006) (noting that initial undercapitalization is a "classic abuse" of the corporate form).

¹²⁹ *Millikin & Co. v. Duro Textiles, LLC*, No. BRCV2002-1364, 2005 WL 1791562, at *13 (Mass. Super. Ct. June 14, 2005). In general, Massachusetts has established that shareholder loans substantially contemporaneous with gross *initial* undercapitalization are factors indicative of an equity interest. See *Yankee Microwave, Inc. v. Petricca Commc'ns Sys., Inc.*, 760 N.E.2d 739 (Mass. App. Ct. 2002); see also *Friedman v. Kurker*, 438 N.E.2d 76 (Mass. App. Ct. 1982); *Albert Richards Co. v. Mayfair, Inc.*, 191 N.E. 430 (Mass. 1934).

¹³⁰ The Wisconsin Supreme Court has established three factors necessary for an insider debt to be recharacterized as equity, one of which is that the corporation's capital is unreasonably small. *Gelatt v. DeDakis (In re Mader's Store for Men, Inc.)*, 254 N.W.2d 171, 185 (Wis. 1977). Similarly, the Rhode Island Supreme Court looks to gross undercapitalization, among other factors, to determine whether recharacterization is appropriate. *Tanzi v. Fiberglass Swimming Pools, Inc.*, 414 A.2d 484, 488–91 (R.I. 1980) (virtually no security for loan by lender in complete control over corporation capitalized

company has sufficient initial capitalization, debt recharacterization on the basis of a period of inadequate capitalization risks converting legitimate loans into capital contributions.¹³¹ Undercapitalization developing down the timeline of a company's existence does not carry the same indications of intent to get the benefits of equity without its consequences.

Courts undertaking a recharacterization analysis have not provided any indication as to what constitutes an acceptable amount of debt relative to equity for a loan to be respected in bankruptcy. In a time when typical debt/equity ratios can be as high as 30-to-1,¹³² and traditional outside financing is hard to come by,¹³³ insiders seeking to maintain a company's operations by extending funding have no foundation to determine the legal protection of their loans in bankruptcy. Indeed, in *In re Submicron Systems*, the plaintiff's expert put forth evidence of the debtor having a debt capacity ratio of 900-to-1.¹³⁴ Nonetheless, the court found the intent of the parties was to create debt, and therefore did not find such a high ratio meaningful.¹³⁵

It is important that courts get rid of the traditional notion that loans contemporaneous with subsequent undercapitalization are influential to debt recharacterization. When existing lenders make "loans to a distressed company, they are trying to protect their existing loans and traditional factors that lenders look at ([] capitalization, solvency, collateral, ability to pay cash

with only \$3000 and doing over \$200,000 in business, resulted in court finding contributions to "risk capital rather than bona fide loans"). However, neither court drew any distinction between initial and subsequent undercapitalization.

¹³¹ Following the individualized understanding of the adequacy of a particular company's capitalization, some relevant inquiries may be to look at the cause of the inadequate capitalization, or whether the inadequacy stems from a higher than normal debt/equity ratio.

¹³² See *Introduction to Financial Statement Analysis*, No. B4-6959, 724 PRAC. L. INST. 59, 69 (1991) ("The debt to equity ratio for many banks may be over 30 . . .").

¹³³ See Julie Jargon, *On the Front Lines of Debt Crisis, Luggage Maker Fights for Life*, WALL ST. J., Jan. 9, 2009, at A1 ("[Luggage business] applied the modern American business playbook: Borrow heavily to grow fast. The strategy worked—until the credit crisis threw out those rules."); Jeffrey McCracken & Vanessa O'Connell, *Wave of Bankruptcy Filings Expected from Retailers in Wake of Holidays*, WALL ST. J., Jan. 12, 2009, at B1 ("Retailers are particularly vulnerable in the current downturn after a decade of buoyant consumer spending, which encouraged them to overexpand and overborrow. Now, the banks and private investors who financed the boom are pulling back.").

¹³⁴ 291 B.R. at 324.

¹³⁵ *Id.* at 327.

interest and debt capacity ratios) do not apply as they would when lending to a financially healthy company.”¹³⁶

Furthermore, inadequate capitalization is a highly factual inquiry “and may vary substantially with the industry, company, size of the debt, accounting methods employed and like factors.”¹³⁷ Therefore, the Fourth Circuit’s *Dornier Aviation* decision that “the objective indicia of an arm’s-length negotiation”¹³⁸ governs the characterization of a transaction as debt or equity is difficult to square with the subjective standard applicable to sufficient capitalization. The Third Circuit’s *Submicron Systems* “intent of the parties”¹³⁹ inquiry is also inconsistent with an inquiry into whether a debtor was undercapitalized at the time of the transaction—while the “intent of the parties” is certainly subjective, intention to extend a loan and get repaid with interest is not antithetical to having an inadequately capitalized debtor. The subjective nature of a capitalization inquiry¹⁴⁰ is inconsistent with the prevailing circuit courts’ debt recharacterization tests.

Courts considering whether recharacterization is appropriate in a certain instance must take notice that “[u]ndercapitalization is not insolvency.”¹⁴¹ Without this understanding debt recharacterization will work to penalize insiders for extending loans to viable, although struggling, companies.

C. Creditworthiness (Ability to Obtain Financing from Independent Sources)

The currently stalled lending environment makes a debtor’s creditworthiness a particularly unreliable factor in a debt recharacterization analysis.¹⁴² The most striking drawback of creditworthiness as an indicator

¹³⁶ *Id.* at 325 (citing *Braas Sys., Inc. v. WMR Partners (In re Octagon Roofing)*, 157 B.R. 857 (N.D. Ill. 1993)).

¹³⁷ *Brighton*, *supra* note 14, at 43.

¹³⁸ *Dornier Aviation*, 453 F.3d at 234.

¹³⁹ *Submicron Sys.*, 432 F.3d at 457.

¹⁴⁰ *See United States v. Colo. Invesco, Inc.*, 902 F. Supp. 1339 (D. Colo. 1995).

¹⁴¹ *Baldi v. Samuel Son & Co.*, 548 F.3d 579 (7th Cir. 2008) (fraudulent conveyance action where trustee did not establish debtor’s insolvency and holding that undercapitalization is not interchangeable with insolvency).

¹⁴² *See, e.g., Skeel & Krause-Vilmar, supra* note 17, at 278 (“Creditworthiness . . . is flawed . . . since it may be difficult to determine whether an outside creditor would make a loan . . .”).

for debt recharacterization is that capital markets are in dire straits, undermining the creditworthiness of most potential debtors.¹⁴³

The concept of insolvency arises in the creditworthiness inquiry, in addition to capitalization sufficiency inquiries. The Bankruptcy Code adopted a broad understanding of insolvency—it defines insolvency under a “balance sheet test.”¹⁴⁴ Such a definition seems to be in accord with traditional views that “[a] company is typically deemed ‘insolvent’ when its debts exceed the fair value of its assets.”¹⁴⁵ As a company’s flirtation with insolvency waxes and wanes, so too does that company’s creditworthiness.¹⁴⁶ Therefore, a vicious cycle is obvious: high debt levels among businesses draw them closer to insolvency, resulting in lower credit

¹⁴³ See Kelly Spores, *Predictions for Entrepreneurship in 2009*, WALL ST. J., Dec. 30, 2008, <http://blogs.wsj.com/independentstreet/2008/12/30/predictions-for-entrepreneurship-in-2009>:

Access to credit may ease for the most creditworthy entrepreneurs, but it will still be very difficult for many. Venture-capital and angel investors are expected to tighten further, and banks will continue to be leery about whom they lend to. Friends and family, whose retirement accounts and home values have tanked, aren’t likely to come to the rescue.

See also Covell, *supra* note 3, at A1 (“Even healthy companies are being choked by the lack of credit lines and bank loans.”). But see *HSBC Establishes a Fund to Aid Smaller Businesses: New Global Program Allocates \$5 Billion to Ease Credit Crisis*, REUTERS NEWS SERVICE, Dec. 8, 2008, available at <http://online.wsj.com/article/SB122868298896086183.html>.

¹⁴⁴ 11 U.S.C. § 101(32)(A) (2006) (“The term ‘insolvent’ means . . . financial condition such that the sum of such entity’s debts is greater than such entity’s property, at a fair valuation . . .”). The “balance sheet test” is distinguishable from the “equity test,” which is the ability to pay debts as they come due. See Robert J. Stearn, Jr., *Proving Solvency: Defending Preference and Fraudulent Transfer Litigation*, 62 BUS. LAW. 359, 360–61 (2007). Regardless of the two previously mentioned tests for insolvency, proving the same is not a simple matter. Issues such as choosing to establish valuation as a going concern or as a liquidating entity are important and will produce different results. See *id.* at 367–73. Furthermore, the date of valuation, and establishing values of liabilities, are critical issues for a solvency determination. *Id.* at 373–78, 381–84.

¹⁴⁵ John E. Moose & Patrick M. Jones, *Is It Debt, or Is It Equity? How the Classification of Hybrid Securities Can Turn a Good Company Bad*, 26 AM. BANKR. INST. L.J. 32, 32 (2007).

¹⁴⁶ Remus D. Valsan & Moin A. Yahya, *Shareholders, Creditors, and Directors’ Fiduciary Duties, A Law and Finance Approach*, 2 VA. L. & BUS. REV. 1, 39 n.111 (2007) (article discussing fiduciary duties near the point of insolvency). Certainly, myriad other factors contribute to creditworthiness, such as ability to repay debts as they come due and outside credit ratings by firms such as Standard & Poor’s. See Lee B. Shepard, Note, *Beyond Moody: A Re-Examination of Unreasonably Small Capital*, 57 HASTINGS L.J. 891, 916–17 (2006).

ratings and therefore less ability to obtain financing (at affordable rates)¹⁴⁷ for potentially successful projects or necessary business expenses that would ultimately reduce debt levels (i.e. amassing inventory in peak sales seasons to meet demand). Such a seemingly unavoidable cycle results in an inability to obtain outside financing, which, unfortunately, according to courts in the debt recharacterization context, “is strong evidence that advances were capital contributions rather than loans.”¹⁴⁸

Furthermore, it is an unlikely assumption that any rational insider would invest equity in an uncreditworthy, or questionably solvent, company. Such an investment would be practically worthless.¹⁴⁹ Therefore, a more rational assumption is that insolvency is “evidence supporting an investor’s assertion that it was legitimately concerned about repayment of its advance,” therefore intending the advance to be treated as debt.¹⁵⁰ However, as discussed, courts addressing debt recharacterization use insolvency and (as I lump the two together) creditworthiness to indicate a “lender’s” attempt to nominally advance debt, while intending an equity contribution.¹⁵¹

Finally, the very existence of debtor in possession financing (DIP financing), highlights the inappropriateness of creditworthiness to a debt recharacterization analysis.¹⁵² DIP financing is attributed primacy in

¹⁴⁷ See Marc I. Steinberg, *Examining the Pipeline: A Contemporary Assessment of Private Investments in Public Equity (“PIPES”)*, 11 U. PA. J. BUS. & EMP. L. 1, 20 (2008) (“[L]enders frequently will require the subject company to agree to onerous financial and operational covenants—concessions with respect to which the company may be unwilling or simply unable to adhere.”); *The Credit Crisis: Financial Engine Failure*, ECONOMIST, Feb. 9, 2008, at 79 (stating that a Federal Reserve survey of bank lending showed that “a good number of banks had imposed stricter lending standards and higher rates on loans . . .”).

¹⁴⁸ Brighton, *supra* note 14, at 43 (citing *In re Autostyle Plastics*, 269 F.3d 726).

¹⁴⁹ Wilton & Moeller-Sally, *supra* note 18, at 1265–66.

¹⁵⁰ *Id.* at 1266.

¹⁵¹ *Id.*

¹⁵² The severity of the credit freeze is exemplified by the tightening of the DIP market. See Jeffrey McCracken & Paul Glader, *Tronox Nears Chapter 11*, WALL ST. J., Jan. 12, 2009, at C1 (“The company has been on the market for [DIP financing] for several months. Since the summer, such lending has largely dried up as part of an overall credit crunch.”); Jeffrey McCracken & Paul Glader, *‘DIP’ Loans are Scarce, Complicating Bankruptcies*, WALL ST. J., Oct. 17, 2008, at C1 (“Credit has gotten so tight in recent weeks that companies contemplating a bankruptcy filing can’t find the cash needed to get through the process.”). But see Matthias Rieker, *Citi’s Loan to LyondellBasell Shows Banks’ Interest in DIPs*, DOW JONES NEWSWIREs, Jan. 9, 2009.

bankruptcy payouts.¹⁵³ DIP financing exists at a time when a company is technically not creditworthy, i.e. it is under the protection of bankruptcy laws. Therefore, it is inconsistent to use creditworthiness to subordinate an insider's loan through recharacterization, while giving near-absolute priority to loans issued by an outsider as DIP financing while the debtor is by definition uncreditworthy.

Continued use of weak creditworthiness as a proxy for debt recharacterization could have the effect of preventing insiders from "ever loaning money to a company experiencing distress."¹⁵⁴ The commonality of high debt levels within American businesses, and the credit crunch's effect of companies looking inward for debt-funding, makes creditworthiness a very imperfect measure for whether a purported debt transaction is "really" equity.

D. Presence of Security

The existence of security behind a transaction is favored by the courts as highly indicative of a loan.¹⁵⁵ Through observing loan formalities, such as granting security for advances, "lenders can point to [this] hallmark[] of an arm's-length transaction in response to a challenge to their liens from unsecured creditors."¹⁵⁶ This is problematic for at least three reasons: (1) the effect of encouraging insider security interests potentially to the detriment of

¹⁵³ 11 U.S.C. § 364(a) (2006) ("If the trustee is authorized to operate the business of the debtor . . . the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) . . . as an administrative expense."). Section 507(a) attributes secondary priority (behind domestic support obligations, which are typically inapplicable to businesses) to "administrative expenses allowed under section 503(b)" *Id.* § 507(a)(2). Upon distribution of property of the estate, Section 726 requires "payment of claims of the kind specified in, and in the order specified in, section 507" before all other claims. *Id.* § 726(a)(1).

¹⁵⁴ Brighton, *supra* note 14, at 43

¹⁵⁵ See *Submicron Sys.*, 432 F.3d at 457 (affirming the district court's decision not to recharacterize the claims as equity, the court found significant that notes were recorded as secured debt on both SEC filings and UCC financing statements); *In re Autostyle Plastics*, 269 F.3d 726, 750 ("The absence of a security for an advance is a strong indication that the advances were capital contributions rather than loans.") (citing *Roth Steel Tube Co.*, 800 F.2d 625, 631 (6th Cir. 1986)); *In re Radnor Holdings Corp.*, 353 B.R. at 839 (fact that loans were secured interests aided decision not to recharacterize). But see *In re Airadigm Commc'ns*, 376 B.R. at 909–10. *In re Airadigm Communications* dealt with a non-insider situation where loans could only be repaid by surrendering collateral. *Id.* According to the court, this indicated a debt. *Id.* However, the court found significant that the lender was not a shareholder of the debtor, indicating that if the lender was an insider the court would have been more skeptical of the transaction. *Id.*

¹⁵⁶ Sussman & Klein, *supra* note 122, at 2.

other creditors; (2) the fact that often unencumbered assets to back an insider's loan are nonexistent; and (3) the inconsistent level of importance attributed to security.

On a practical level, using security as an indicator of a true debt transaction may encourage insiders to act to the detriment of other creditors. Indeed, "with shareholder loans, a context where the risk of undermining creditor recoveries is both systematic and high, the moral assumption that secured loans will have the effect of hindering creditors is fully warranted."¹⁵⁷ The presence of security may also encourage waste¹⁵⁸ by protecting an extension of funds to a failing company, resulting in "overinvestment" (investment in a company that realistically should fail).¹⁵⁹ On pure market efficiency grounds, such equity masquerading as debt for bankruptcy protection purposes should be discouraged. Courts, however inadvertently, facilitate and encourage these practices by giving "debt" protection in bankruptcy if there is collateral backing the transaction.¹⁶⁰

Regardless of the practical implications, the absence of security backing an insider's transaction falls short of being an accurate indication of equity. First, often a company on the brink of insolvency and approaching bankruptcy has all its assets encumbered and therefore may be unable to obtain outside financing without entering into difficult to procure

¹⁵⁷ Skeel & Krause-Vilmar, *supra* note 17, at 276.

¹⁵⁸ See Gelter, *supra* note 15, at 483 (secured debt "in some situations allows efficient projects to go forward that otherwise would not receive finance, but also enables transfers of value from original unsecured creditors to a coalition of shareholders and new, secured creditors.").

¹⁵⁹ See *supra* notes 16–17; see also Adler, *supra* note 16, at 603 ("[A]lthough unexpected changes in the economy and failed gambles by good firms are possible, such events may be less likely than the traditional reason for business insolvency, a bad idea poorly executed."). Security is problematic because "collateral sometimes leads to overinvestment, but it can be used to solve an underinvestment or debt overhang dilemma." Skeel & Krause-Vilmar, *supra* note 17, at 272. Overinvestment is equated with "unwarranted continuation." *Id.* at 279. Skeel and Krause-Vilmar argue that "eve-of-insolvency" secured loans nearly always lead to overinvestment and should therefore be absolutely discouraged. *Id.* at 274.

¹⁶⁰ Adler, *supra* note 16, at 605 ("Unfortunately, courts tend not to understand the nature of overinvestment and tend to feel they are serving investors when they decline to void repayments of loans made to 'save' financially distressed firms."). However, as discussed in Part II, *supra*, the Bankruptcy Code provides numerous remedies beyond debt recharacterization for such creditor hindering conduct.

subordination agreements or accepting overly onerous terms.¹⁶¹ The insider therefore becomes an important source of funds. However, security may be unavailable for the insider's loan. As potentially unwilling to infuse cash that courts will deem equity, the insider may decide against what she would otherwise intend to be a loan.¹⁶² Therefore, requiring security to establish a loan works to discourage such funding, regardless of any under-or-overinvestment analysis.

Finally, courts inconsistently assert the importance of security to support a debt characterization. In *In re Transystems, Inc.*, a parent made advances to its subsidiary, evidenced by a demand note and secured by substantially all the assets of the debtor subsidiary.¹⁶³ The Fifth Circuit nonetheless affirmed the bankruptcy court, finding the transactions at issue to be capital contributions and not loans.¹⁶⁴ The facts supporting this finding were that no demand was made on the note (ironic, due to the nature of *demand* notes), the debtor was not creditworthy, the parent deemed its subsidiary in need of capital to achieve its potential, and the parent's increased managerial role.¹⁶⁵ In contrast, in *In re Submicron Systems Corp.*, the court concluded that at the time of the extension of funding, the debtor was insolvent,

and there was no collateral available to actually secure the 1999 fundings. Defendants were well aware of this fact. However, it is also evident that the parties *intended* the 1999 fundings to be *secured debt* and that defendants were protecting their past investments (secured debt) by the additional loans. Under these circumstances, the court declines to recharacterize the 1999 fundings as unsecured debt.¹⁶⁶

Therefore, it is clear that, at least in the Third Circuit, security is relatively unimportant when compared with intent. *Submicron Systems* is a more recent case than *In re Transystems, Inc.*, and *Submicron Systems* presents one of the prevailing tests for debt recharacterization—intent of the parties. Nevertheless, security is attributed varying levels of importance, even considering similar surrounding factual circumstances. Such inconsistency

¹⁶¹ The current hesitation among lending institutions to extend loans is an analogous situation whereby companies have a difficult time obtaining any type of loan, much less one with favorable terms.

¹⁶² Presumably, this would meet the Third Circuit's test as described in *Submicron Systems Corp.*, 432 F.3d at 457–58.

¹⁶³ 569 F.2d at 1365.

¹⁶⁴ *Id.* at 1369.

¹⁶⁵ *Id.* at 1369–70.

¹⁶⁶ *In re Submicron Sys. Corp.*, 291 B.R. at 327 (emphasis added).

contributes to the general lack of notice to insiders regarding whether and when their transactions will be respected in bankruptcy.

E. A Final Word on Current Inquiries

The very nature of insider lending is arguably either less sophisticated or less likely to rely on formalities than traditionally obtained loans from banks or other outside lenders. The effects of the credit crisis—such as tightened lending standards and decreased consumer demand—mixed with traditionally high debt levels held by United States businesses, indicate a current and future increase in insider lending. Courts should therefore change what they require to satisfy classification as an insider loan in bankruptcy.

The above analysis of the major factors used by courts to make a decision in favor of or against debt recharacterization in a given bankruptcy situation shows that the inquiries need to be changed. The combination of using inappropriate factors, and applying the same inconsistently, results in difficulties for insiders “to predict . . . the outcome of debt recharacterization cases”¹⁶⁷ This difficulty in turn discourages extensions of funding by those most likely to understand a company’s prospects for success, and most interested in seeing the realization of that potential. Coupled with the lack of readily available business loans from independent institutions, courts using a combination of the wrong factors as dispositive of equity contributions will cause more harm in the coming years as business bankruptcies and debt recharacterization claims rise in number.

V. A PROPOSAL FOR NEW INQUIRIES

Companies unable to find sufficient operating capital often turn to their insiders and shareholders for additional liquidity.¹⁶⁸ “With the credit crunch drying up the capital markets over the past year, the next wave of major bankruptcies will present issues regarding the validity of such” transactions.¹⁶⁹ The increasing necessity of insider lending will result in more situations where insiders have a greater perception of the “true” risk presented by a loan to a corporation on given terms . . . than outsiders recognize, and . . . are unable to articulate and convey . . . [this] superior judgment to the prospective outside lenders at a reasonable cost.”¹⁷⁰

¹⁶⁷ Wilton & Moeller-Sally, *supra* note 18, at 1264.

¹⁶⁸ Sussman & Klein, *supra* note 122, at 1.

¹⁶⁹ *Id.*

¹⁷⁰ Clark, *supra* note 17, at 539.

The uncertainty of recharacterization has potentially chilling effects on business. Businesses and their counsel have a hard time predicting a court's likely position on insider transactions. Increased judicial protection will create "incentive for the investor to contribute the funds to the company in an effort to return to profitability."¹⁷¹ This is also consistent with the Bankruptcy Code's intent to treat the class of creditors broadly by including within the definition of "claim" all "*legal obligations* of the debtor, no matter how remote or contingent."¹⁷² For judicial treatment of insider lending cases to be consistent with the Bankruptcy Code and avoid hindering business profitability in an anomalous financial climate, courts must change the current prevailing debt recharacterization tests as exemplified by *Dornier Aviation* and *Submicron Systems*, and look to different factors as proper indications of the often gray area between debt and equity.

The current tests look to common objective indicia of debt to determine whether a particular transaction is a debt, evidenced by an eleven factor list where no single factor controls the outcome.¹⁷³ Rather than fitting particular facts of a particular case with multi-factor tests, courts force multi-factor tests to fit particular facts. A new debt recharacterization inquiry would justifiably focus on the insider transaction's interference with other creditors (partially represented by whether the loan is "visible" or open to existing and future creditors), whether the transaction involves positive or negative covenants, and the existence and type of a repayment plan accounting for both principal and interest.

A. Creditor Interference and Visibility of the Transaction

Courts addressing the issue need to distinguish between insider loans that benefit the company without impairing creditor recovery, and those loans that do have potential to unfairly degrade the value of creditor recoveries.¹⁷⁴

¹⁷¹ Jonathan A. Carson, *Pre-Petition Capital Contributions: The Road to Equitable Treatment in Bankruptcy*, 1999 COLUM. BUS. L. REV. 403, 435. Indeed, "[t]he Bankruptcy Code already encourages post-petition investing through [Section] 507 by allowing post-petition investments priority as administrative expense claims; however, no such incentive exists in the pre-petition stage." *Id.* (citing 11 U.S.C. § 507); see also *supra* notes 135–36 and accompanying text.

¹⁷² H.R. REP. NO. 95-595, at 309 (1977); S. REP. NO. 95-989, at 22 (1978).

¹⁷³ See *supra* Part III.

¹⁷⁴ Lynn LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 327–28 (explaining that owners of small businesses often hang on to their distressed businesses beyond the point of economic viability, causing creditors to recover less than had the debtor business filed in bankruptcy earlier).

Insider loans can negatively impact creditor recovery by either postponing inevitable bankruptcy and associated payments, or encumbering company assets or other things of value.¹⁷⁵ Nonetheless, optimism about business recovery in United States corporate law generally encourages shareholder loans. However, this must be tempered by any harm unnecessarily posed to creditors. In the context of creditor recovery in bankruptcy, insider gambling, or “overinvestment,” activity is a particularly acute problem.

Forcing insider loans to be open and visible to other parties with potential claims against the debtor helps to solve the risks posed by insiders extending funds. Requiring visibility allows creditors to approach the debtor and alter the terms of their debt covenants should a creditor feel adversely affected by the insider transaction.¹⁷⁶ This puts risk assessment in the hands of parties with an interest in the debtor, rather than with courts which may not be particularly suited to undertake an exhaustive analysis of risks posed by an insider’s “loan.” To be sure, existing state law remedies and Bankruptcy Code causes of action help creditors avoid losing portions of their entitlements that may result from improper insider dealings. However, requiring insider loans to be open to the world to receive debt treatment not only remedies the problem of distinguishing debt from equity but also helps to resolve the problem of interference with existing creditors.

Requiring notice is likely an inexpensive (partial) resolution to any risks posed to creditors by interested insiders extending “loans” to their companies in a time of distress. Admittedly, notice through visibility has little bearing on the practical differences between debt and equity, and whether a particular transaction creates debt or equity. However, using notice begins to solve the problem of fairness posed by drawing lines in the sand between transactions carrying indications of both debt and equity.¹⁷⁷ It also follows in line with

¹⁷⁵ Such a dilemma is noted by Skeel and Krause-Vilmar as the “ill founded loan problem.” Skeel & Krause-Vilmar, *supra* note 17, at 271; *see also* Gelter, *supra* note 15, at 478.

¹⁷⁶ It should be noted that, due to the Automatic Stay of Section 362(a), once in bankruptcy, covenants in a company’s pre-petition debt no longer apply. 11 U.S.C. § 362(a)(3), (6) (2006); George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 912 (1993) (“The initiation of bankruptcy proceedings automatically stays creditor enforcement rights and thereby removes the principal governance lever of the debtholders. As a consequence, restrictive covenants in the firm’s prepetition debt cease to have any effect on the decisions of the firm.”).

¹⁷⁷ Moose & Jones, *supra* note 145, at 69–70:

From a litigation standpoint, representatives of a debtor’s bankruptcy estate should determine whether hybrid securities are likely to be characterized as debt or equity The process that courts may employ to determine whether to treat hybrid

Congress's decision to bring under the umbrella of "claim" nearly all legal interests in the debtor.¹⁷⁸

B. What Type of Rights Does the Transaction Establish?

The contractual nature of debt requires an individualized inquiry into a claimant's particular transaction with the debtor.¹⁷⁹ This, in part, requires a risk analysis:

The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them.¹⁸⁰

Therefore, the level and style of control obtained through the transaction—which impacts the party's leverage over the debtor—is an important inquiry in a debt recharacterization analysis.¹⁸¹

The predominance of debt recharacterization claims against insider transactions necessitates judicial consideration of insider control over the debtor.¹⁸² However, the proper inquiry is to look at what is granted by the

securities as debt or equity is not well settled and should evolve as the issue becomes increasingly common in bankruptcy-related litigation.

¹⁷⁸ See *supra* notes 172–73 and accompanying text.

¹⁷⁹ Interview with Paul Rose, Professor of Law, Michael E. Moritz College of Law, in Columbus, Ohio (Feb. 15, 2009). In comparison with debt, equity is more statutorily protected: i.e. existence of statutory duty requirements, director and officer duty of loyalty concerns, and both federal and state securities laws. *Id.*; see also Poindexter, *supra* note 96, at 252 (“The rigidity (or, conversely, fluidity) of obligations and rights between the investor and the firm will inform the differentiation between equity and debt.”).

¹⁸⁰ *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943) (emphasis omitted).

¹⁸¹ Triantis, *supra* note 172, at 910 (discussing agency problems existing between a company, its shareholders, and debt holders, with respect to incurring risk and making investment decisions).

¹⁸² *Blasbalg v. Tarro (In re Hyperion Enters., Inc.)*, 158 B.R. 555, 561 (Bankr. D.R.I. 1993); see also *Dornier Aviation*, 453 F.3d at 229–30. It is hard to question the commercial reasonableness of the parent's inventory transactions with its debtor in *Dornier Aviation*. Couple this with the fact that circuit courts are rarely, if ever, presented with pleas for debt recharacterization of outside creditor loans, and it seems that the

contract controlling the transaction. If the openness requirement¹⁸³ is followed, an agreement outlining rights will likely exist, regardless of the size and sophistication of the parties to the transaction. Furthermore, insiders, by default, have significant control over the debtor company. Therefore, criticizing the rights granted with respect to the challenged transaction properly assesses the debt or equity qualities associated with such transaction.

C. Existence of a Repayment Plan

A traditional characteristic of a debt obligation is the presence of a fixed maturity date and payment schedule, and presence of a fixed interest rate and interest payments.¹⁸⁴ The fixed nature of these requirements is questionable as an indication of debt. Indeed, "there is no compelling reason to treat a fixed maturity date as a sine qua non of debt. Lack of a fixed maturity date is not a sine qua non of equity."¹⁸⁵ Instead, the mere existence of a repayment plan, subject to compromise based on traditional contract principles, is a requirement that encourages lending in all types of economic environments, and allows a debtor company to focus on its business and profitability.¹⁸⁶ Furthermore, the requirement of a repayment plan, without necessarily requiring a fixed payment schedule, imposes a level of flexibility that supports the widespread understanding that "recharacterization should not be used to discourage good-faith loans."¹⁸⁷

However, the flexibility imposed by this suggestion is not absolute. Two commonly accepted principles impose limits. First, debt is often represented

parent/subsidiary relationship in *Dornier Aviation* was more important to the court's decision than it let on.

¹⁸³ See *supra* Part V.A.

¹⁸⁴ See *Dornier Aviation*, 453 F.3d at 233, 233–34 (listing the eleven *In re Autostyle Plastics, Inc.* factors that "speak to whether the transaction 'appears to reflect the characteristics of . . . an arm's length negotiation.'").

¹⁸⁵ David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499, 508 (1994).

¹⁸⁶ Debt financing itself is intended to provide the issuer flexibility. COX & HAZEN, *supra* note 56, at § 18.01 ("Debt financing . . . provides more flexibility because there generally is no need for prior shareholder approval."). Debt financing, however, is different from a loan extended with either security or a contractual agreement issued as consideration. Both situations create "debt," though, so I lump them together.

¹⁸⁷ *Dornier Aviation*, 453 F.3d. at 234.

by payments that do not fluctuate according to the company's profitability,¹⁸⁸ and, absent state statutory law, does not include voting rights.¹⁸⁹ Profitability might not, on the face of the agreement, affect required payments, yet the contractual nature of debt may create leniency. One's status as an insider should not affect mutual contract alteration. Second, a near universal quality of equity is that the holder's return is inextricably linked to the issuer's profitability.¹⁹⁰ Therefore, a strong inquiry for distinguishing debt and equity is merely looking to the type of payment made to the debt or equity holder.

D. A Simple Combination Applicable to Both Simple and Complicated Transactions

An analysis of whether the transaction at issue interferes with existing creditors and is visible to parties interested in the debtor's financial situation, the types of rights created by agreement, and the payments received by the "lender," has the virtues of simplicity, notice, and accuracy. Such virtues are missing from the current debt recharacterization analysis. The complicated, non-determinative, sometimes objective, and sometimes intent-based inquiries create confusion. Inconsistency within courts applying the current test from *Roth Steel Tube Co.*¹⁹¹ adds to the complication.¹⁹² The last thing a

¹⁸⁸ See generally David P. Hariton, *Equity Derivatives, Inbound Capital and Outbound Withholding Tax*, 60 TAX LAW. 313 (2007). But see COX & HAZEN, *supra* note 56, at § 18.02 (long-term corporate debt instruments have "led to the view of bondholders as 'joint heirs in the corporate fortunes—participants in the success or failure who have been given preferential rights in the common hazard'" (quoting ARTHUR S. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 236 (5th ed. 1953))).

¹⁸⁹ COX & HAZEN, *supra* note 56, at § 18.03 ("Conditional voting rights make bonds look more like shares of stock, and it is questionable whether in the absence of a statute such protections can be put into the indenture agreement . . .").

¹⁹⁰ Hariton, *supra* note 188, at 348; COX & HAZEN, *supra* note 56, at § 13.01 ("A share of stock is primarily a profit-sharing contract, a unit of interest in the corporation based on a contribution to the corporate capital."). Among shareholder rights is the "right to participate ratably in dividend distributions when declared by the management." *Id.*

¹⁹¹ *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625, 630 (6th Cir. 1986).

¹⁹² There is also an inconsistency between debt recharacterization test factors and legitimate outside bankruptcy creditor/debtor efforts to mutually benefit the parties to a loan. The very idea of debt workouts—essentially negotiations between the creditor and debtor where payment schedules and other terms are often altered—is such an example, indicating that many of the commonly used criteria distinguishing debt and equity need to be changed. A debtor is often quite important to a creditor supplier and therefore the supplier's best interests will include the debtor's survival. Such creditors may choose to alter repayment terms to assist the debtor through its rough financial condition. Workouts essentially provide the debtor with more favorable terms than would otherwise exist,

struggling business and its potential benefactor need is to worry about whether a court will respect the funding as a loan, and treat it *pari passu* with other debt holders should the unfortunate occur. Certainly, the great benefit of corporate law is the breadth of corporate finance options that exist.¹⁹³ Its great headache is the myriad ways courts attempt to deal with financial ingenuity. The above three proposed factors are an attempt to reduce this headache in forthcoming debt recharacterization claims.

VI. CONCLUSION

Lender confidence and ability to issue credit has slowed significantly. Debt is, and will remain, an integral component of successful business practices, so the inability to borrow funds will negatively impact business operations. Where independent, outside funds are largely unavailable, to remain viable businesses will likely turn to alternative sources of funding—capital calls, extending repayment terms on existing lines of credit, and increasingly turning to investors, directors and officers, or other insiders. The likelihood that the issue of debt recharacterization will come before numerous bankruptcy courts in the coming years brings the need to accurately characterize claims against a bankrupt debtor, while taking into consideration legitimate changes in lending practices. United States courts need to be sensitive to protecting both creditors and successful rescue attempts brought on by an uncontrollable and novel credit situation.¹⁹⁴

therefore calling into question the importance of the fixed payment and maturity date requirements, and adequacy of capitalization requirement. See *In re Autostyle Plastics, Inc.*, 269 F.3d at 750.

¹⁹³ Preferred shares are illustrative of this benefit. Preferred shares pervade all types of business structures, and are especially common in the venture capital world. See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 284 tbl.1 (2003). Preferred shares are notable in the debt recharacterization context because they blur the line between debt and equity. See Hariton, *supra* note 185, at 348 (“Preferred stock . . . is a fixed income instrument just like debt, except that investors lack creditor’s rights with the equity holders in the event of the issuer’s bankruptcy. Investors in preferred stock generally do not vote or otherwise control the affairs of the issuer.”); see also COX & HAZEN, *supra* note 56, at § 18.07.

¹⁹⁴ See Gelter, *supra* note 15, at 482 (“Policymaker . . . are facing a tradeoff between creditor protection and the desirability of potentially successful rescue attempts in firms on a trajectory towards insolvency.”).

Insiders are parties “most likely to have motivation to salvage a floundering company.”¹⁹⁵ Courts routinely hold the concern of establishing disincentives to support a troubled company to be an important consideration when deciding debt recharacterization claims. However, inconsistent and ambiguous treatment of debt recharacterization discourages “owners and insiders of struggling [firms from undertaking legitimate] efforts to keep a flagging business afloat.”¹⁹⁶ Changing debt recharacterization will encourage insider lending in a time of economic instability that negatively impacts businesses, whether successful or close to bankruptcy. Extreme market conditions should not be decisive of successful businesses being subjected to the risk of bankruptcy, and those on the edge being pressured into bankruptcy. If courts allow it, insider lending can provide a significant partial remedy.

¹⁹⁵ *In re Submicron Sys.*, 291 B.R. at 325 (quoting *In re Octagon Roofing*, 157 B.R. 852, 858 (N.D. Ill. 1993)) .

¹⁹⁶ *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1298, n.1 (10th Cir. 2004)